

Lending to Technology Companies: Collateral versus Cashflow?

BY HUGH C. LARRATT-SMITH

As the U.S. changed from a manufacturing to a service-based economy, ABL lenders faced a growing array of challenges, including lending to software companies and coping with rapid hardware obsolescence. Hugh C. Larratt-Smith speaks with key lenders in this industry and learns how lending to technology has changed in the last 40 years.



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By the mid-1970s, the steady exodus of New England manufacturing companies to the South was gathering momentum, leaving towns and cities with shuttered factories and unemployed workers. Tax revenues were plummeting. Roads and highways were deteriorating as state and municipal governments struggled financially. The disappearance of traditional New England ABL customers — shoe, garment and furniture manufacturers — meant loan demand was declining. Finished goods inventory collateral — the knife and spoon of traditional ABL deals — was becoming scarce.

Then “The Massachusetts Miracle” happened. Triggered by new computer technology, Route 128 — the beltway around Boston — became the hotbed for the dramatic shift of corporate America from mainframe computers to mini-computers. New companies like Lotus, Wang, Prime Computer and Digital Equipment prospered, driven, in part, by the proximity of Route 128 to leading universities like MIT. The Massachusetts Miracle launched the second stage of the computer revolution.

Lenders Join the Party

Lenders were eager to join the technology financing party. However, it was challenging to provide credit facilities other than short-term lines of credit to these new types of borrowers. Banks’ credit committees were accustomed to inventory that was predictable and easily liquidated if a borrower went sideways. Equipment term loans were even more difficult because of the rapid changes in technology. In 1979, IBM replaced its corporate workhorse, the Model 360, with the new Model 370, causing appraisal values on Model 360 equipment to plummet. By 1980, the corporate darling of New England — Polaroid — was facing unprecedented technology and management turmoil. To make matters worse for lenders, the best corporate customers were starting to replace short-term borrowings from banks with commercial paper.

Now, let’s move 40 years forward to 2018. With the four-decade shift in the U.S. economy to more services instead of manufactured products, asset-based lenders have adapted to a fast-changing landscape. High growth technology companies represent attractive opportunities for ABL players. But the questions that challenged lenders in 1978 still echo today. Am I making a collateral-good loan, or is it a cash-flow loan masquerading as a collateral loan? Will my borrower get side-swiped by technological disruption?

The Hardware/Software Dilemma

As middle market technology companies emerged in the 1990s, senior secured lenders viewed technology deals as two halves of the clamshell: hardware and software. Hardware appealed to lenders because it

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Route 128 and some of the technology companies that were part of the "Massachusetts Miracle."

Picture Source: Sswonk/wikipedia.com

represented a fungible asset that a lender could touch and feel. Software, on the other hand, was scarier. By the end of the decade, Wells Fargo and Silicon Valley Bank had pioneered lending against mission-critical software that generated predictable, recurring cashflow. These borrowers were appealing because their cost of goods sold was minimal once corporate users accepted the software. Software companies that successfully "invented once, sold 50 times" generated massive profitability.

John Leonard, head of Technology Finance, Wells Fargo Capital Finance, based in Santa Monica, CA, notes, "Many senior secured cash-flow lenders are now focused in the software space. The depth of the market has increased significantly given the evolution of the tech industry as well as the proliferation of nonbank lenders, which together with established bank lenders like Wells Fargo, create significant financing capacity for both sponsor-backed and non-sponsor backed companies."

Chris Taylor, managing director, Five Crowns Capital Credit Partners in Newport Beach, CA, adds, "We [see] strong growth in tech lending against recurring revenues, especially in the case of software/SaaS businesses. An increasing number of traditional

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banks have now started lending against recurring revenue — generally up to three months of recurring revenue if churn is less than 10% — and there [is] a growing pool of specialty lenders and opportunistic credit funds, including ourselves, that will look at lending up to 12 to 18 months of recurring revenue if churn is in the single digits and margins on that recurring revenue are strong."

In the early days, secured lenders structured loans as pure accounts receivable lending with stretch pieces. Their thinking was "that's what we have always done, and that's what we know." Now, many senior secured lenders will use A/R advance rates as a way to keep the loan amount correlated to the ups and downs of the borrower's business and its assets. Over-advances can be an effective early warning signal — the loan is growing, but the borrower's assets are not. > >

The Risk of Obsolescence

The bread and butter of ABL collateral are inventory and A/R. However, inventory of hardware companies can be difficult to value. Few lenders will advance more than 10% to 20% against finished goods inventory. Jeffrey Wacker, head of U.S. Business Development, Asset Based Lending, TD Bank in New York, explains, “For technology companies, product obsolescence risk directly impacts inventory value, which affects finance-ability and potential borrowing base. In the technology lending arena, it is particularly important to understand the risks of technology and be sure that inventories are managed to minimize obsolescence risk for the company and its lender. Lenders may require more frequent inventory appraisals, the capping of certain categories of inventory in borrowing bases to create a more diversified mix or may institute obsolescence reserves. All of these approaches include real-time understanding of what is changing with regard to the market value of the inventory.”

John Brignola, managing partner, LBC Credit Partners in Philadelphia, adds, “Technology companies typically have risks such as obsolescence or substitution that can have an unforeseen effect on the value of the business. In those instances when the value is impacted suddenly, even the first lien lender may not get out at par.”

As secured lenders learned that the life cycle of technology companies could be very short, many realized collateral liquidations did not offer a way out. With a shoe or garment manufacturer in Providence, Manchester or Lawrence, secured lending players could feel good about getting out through a collateral liquidation. Appraisers could usually peg the liquidation value of a leather cutting machine or a men’s suit material spreading system in New Hampshire down to the last dime. In a computer hardware deal in Silicon Valley, a secured lender wasn’t so sure. Some equipment lenders

Russ in New York and Buffalo, says, “This can create a conundrum for secured lenders. The value of the equipment is highly dependent on software, but how much technology risk is the lender actually taking on, given the pace of technological change? With artificial intelligence manufacturing systems becoming more common, how does a lender evaluate obsolescence risk?”

Comfort in Real Estate

Real estate in data center companies is one of the few sectors where technology lenders feel comfortable lending against single-purpose real estate. However, Graber offers a sobering thought: “A data center can be tricky to liquidate. The contractual terms of data centers with users can be more complicated than the wiring on a NASA space shuttle. Untangling these contracts can take years of litigation. But without these contracts, all you have to liquidate are bricks and mortar.”

Intellectual property can be difficult to quantify. Wacker says, “Oftentimes, senior lenders will lend a percentage of enterprise value often expressed as a multiple of EBITDA. As we see in LBOs and other financing transactions, senior cash-flow lenders (including banks) may provide loans of 30% to 50% of enterprise value, followed by junior lenders that may provide additional incremental loans that total 60% to 70% of enterprise value. The lender’s perspective has a lot to do with how stable they view the cash flows on which the enterprise value is based. But one thing remains true — sustained cash flows are required to service interest and principal. The value of the company is oftentimes much more driven by its cash flow than its assets.”

Many technology financings are not so much cash-flow loans as enterprise value loans. That doesn’t mean the ABL player is forsaking a borrowing base. Secured lenders want a structure to keep the borrowings in line with the health of the business, and advance rates are much more “real time” than covenants. Brignola notes, “As enterprise lenders, we work to establish a value for a business based on its cash flows. For example, we may review a software company’s installed base and licensing agreements as measures of intrinsic value. Once we are comfortable with a level of perceived value, we will spend time evaluating its billing cycles and revenue streams further refining our estimate of enterprise value.”

Dell Computer was not making any money when it tapped the lending marketplace in its early days, but everyone thought it had a bright future. Lenders ignored the negative EBITDA and advanced close to 100% against A/R on the theory that the A/R was a tripwire.

With upward trending EBITDA, a lender might advance 30% to 50% against enterprise value. If EBITDA is trending down, the advance rate might be

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may advance against the software in a sophisticated piece of equipment. In larger equipment, this may be 50% of the capital cost. Garry Graber, partner, Hodgson

10% to 20%. Some lenders reason, "I'm okay if I have 6X equity cushion underneath me." Others do not. Brignola explains, "Downward trending EBITDA businesses are not necessarily a pass for us. If the decline is top line driven, we are likely to be less interested in the business irrespective of an equity cushion. In fact, a substantial equity cushion has minimal influence on our lending decision."

Graber cautions, "Enterprise value can be a shaky concept if it's based on the last equity raise — that's like steering the boat by looking at its wake."

SaaS Makes Revenues Sticky

Enterprise value can be strongly influenced by intellectual property. But, "the mere presence of patents or copyrights does not indicate value in liquidation of intellectual property," says Karthik Vasudevan, who manages Tiger Group's Corporate Valuation Services Division. "Frequently, tech-focused asset-based lenders are lending on recurring revenue assets such as software as a service (SaaS). SaaS can have the feature of high switching costs for an end user, making revenues 'sticky,' and hence creating value in the software and associated contracts. The collateral value of intellectual property will factor into enterprise value, so IP lenders are usually covered if the entity is sold as a going concern in a robust bidding situation."

In today's market, sponsors are buying strong software companies for up to 16X EBITDA or 2.8X recurring revenue. ABL players will lend up to 3.5X EBITDA, which will typically be within the A/R collateral pool. This will be followed by second lien lenders for an additional 3.5X EBITDA. Some ABL players will underwrite the entire first and second lien amount, then syndicate the second lien position to a credit fund or a BDC. "Lenders may finance companies with revenues as low as \$10 million but need the borrower to be generating positive EBITDA and have under 35% debt in the post capitalized structure," Vasudevan says.

Leonard adds, "Senior secured lenders will underwrite to the strength of a company's recurring revenue stream, which provides financing capacity for software companies regardless of their near-term EBITDA profile. As a result, software financings can take on a very traditional, leveraged lending construct (i.e. up to 4.5X first lien, 7.5X second lien for the right deal), or a more recurring-revenue style loan that leverages a company up to ~2X LTM recurring revenue with an initial covenant package tied to recurring revenue and liquidity."

Larger technology deals typically have complicated capital structures. Often, the debt advisor will size the first lien tranche to the borrower's eligible collateral to achieve the lowest cost of the capital structure. In this way, the asset-based loan facilitates the optimum capital structure for the borrower.

The secured lending landscape has evolved dramatically over the past four decades. In the 1970s, many secured lenders saw themselves as lenders of last resort. They wanted to be the sole source of funding for the borrower. They didn't want their collateral to be complicated by other lenders. That meant providing a

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modicum of term debt if the fixed assets appraised well. Today, most secured lenders welcome other participants in the capital structure, particularly in technology deals.

Adding more marketplace color, Leonard concludes, "Private equity activity is robust in this space, and as the market continues to become more competitive, PEGs are competing for smaller deals — making both the lower middle market and core middle market very competitive."

Graber from Hodgson Russ sums up the marketplace, "Ten years ago, two West Coast lenders were the pioneers in the technology lending sector. Today, the marketplace is intensely competitive, with credit funds and BDOs offering more aggressive structures and pricing every day."

In 1975, the unemployment rate in Massachusetts was more than 12%. By the time Silicon Valley launched the third stage of the computer revolution in the early 1990s, unemployment in Massachusetts had plummeted to 3%. The Massachusetts Miracle revived Boston, successfully fueling much of the famous redevelopment of Boston's waterfront, including Faneuil Hall and Quincy Market. [abfj](#)

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